I. INTRODUCTION

Sections 12 and 19 of the Cable Act of 1992 call for regulations that affect vertical relationships -- contract agreements or vertical integration through ownership -- between cable operators, or other multichannel video distributors, and cable program services.[1] In particular, Section 19 of the Act instructs the Commission to develop regulations that deal with agreements granting exclusivity and with agreements offering program services at different prices, or on different terms, to different multichannel distributors. Section 12 instructs the Commission to develop regulations to prevent video distributors from requiring a financial interest in a program service, or from coercing exclusivity from a program service as a condition of carriage. Section 12 also instructs the Commission to write regulations to prevent video distributors from unreasonably restraining the ability of program services to compete by discriminating in favor of program services with which they are affiliated.

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[1]The term "cable program services" is obviously something of a misnomer in this context since these services are also distributed by non-cable technologies, but the term is retained for simplicity. In addition, as used here, the terms "cable program services" or "networks", or more simply "program services", encompasses what the Act refers to as "cable program services" and "satellite broadcast services".

This paper analyzes two of the vertical practices and arrangements these regulations must address: program services charging different prices to different distributors, and program services selling exclusivity rights to distributors. Differential pricing and the granting of exclusivity are common business practices in many, although not all vertical relationships. This is true not only of the supply of cable and similar video services, but also more broadly in the video and entertainment industries as well as in many other industries.

In this paper we explore some of the reasons why suppliers of video programming, and distributors of that programming, adopt these business practices. Our analysis shows how each can improve the efficiency with which consumers are supplied video programming. Differential pricing and exclusivity are so widespread not because they are a means to gain anticompetitive advantages over rivals, but because they offer advantages that benefit the firms involved by improving the efficiency with which the industry functions. Those efficiencies ultimately lead to lower costs and improved programming that benefit viewers.

In many market conditions there is virtually no risk that such practices can become a means for reducing competition, allowing increased exercise of market power by any firm, or harming consumers. At the same time, the analysis shows how difficult it would be to regulate and constrain use of these practices without substantial risk that these efficiencies will be lost and consumers harmed.

On the basis of the analysis in this paper, we recommend that the Commission not adopt blanket prohibitions on either differential pricing for program services or the granting of exclusivity to multichannel video distributors. We also recommend that Commission regulations constrain adoption of these practices only in those limited circumstances where the potential for harm to consumers is clearly demonstrated.

II. THE ECONOMICS OF VERTICAL RELATIONSHIPS

Few subjects in economics have received more attention over the past ten years or so than that of vertical relationships. From this analysis has come an improved understanding of how the careful structuring of vertical relationships, both through vertical contracting and vertical integration, contributes to economic efficiency.[2] Indeed, one of the major contributions of this analysis has been to show that many arrangements and practices previously thought to be anticompetitive were actually ways in which firms could lower their costs and, in turn, their prices to consumers.

The analysis also has yielded an improved understanding of whether various vertical relationships or restrictions can be used by a firm to disadvantage upstream or downstream rivals. The current state of economic learning is that one cannot rule out in all circumstances the possibility that vertical restrictions may be

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[2]For reviews of this literature from a variety of perspectives see Tirole (1988, ch. 4), Perry (1989), and Williamson (1985).

used to disadvantage rivals and result in higher prices to consumers. At the same time, it is clear that only in certain limited conditions is there a risk that vertical contract terms or vertical integration can threaten anticompetitive harm. If these conditions are not present, there is virtually no risk of anticompetitive harm, and it is safe to presume that the pursuit of efficiency, and not the desire to gain an anticompetitive advantage, is the reason firms adopt such vertical practices.

Even in those limited market circumstances in which anticompetitive consequences cannot be unequivocally ruled out, anticompetitive harm is only a possibility, not a certainty. Given the efficiencies that vertical arrangements can produce, detailed analysis is necessary before one can safely conclude that they lead to the increased exercise of market power and that this more than balances the effects of the additional efficiencies.[3]

III. REASONS FOR DIFFERENTIAL PRICING

There are many reasons -- quite apart from any attempt or ability to disadvantage some distributors and exercise increased market power -- why a program service may not charge all distributors the same price or, more particularly, the same price per subscriber. Here we first examine why economies in transaction costs may cause a program service to charge a large cable MSO lower prices per subscriber than it charges smaller cable MSOs, or than

[3]For a similar perspective on judging horizontal combinations, see Williamson (1968).

it charges a distributor using another technology to serve a small number of subscribers. The following sections examine a variety of other factors that may lead to price differences among buyers.

A. Volume Discounts for Large Distributors

Program services incur costs of doing business in addition to the direct costs of acquiring and assembling packages of programs and physically delivering their services to video distributors. Important among these are the costs of convincing distributors of the value of their programming, negotiating contracts with distributors, and enforcing those contracts.

Importantly, these costs are not borne only the first time a program service negotiates an affiliation agreement with a cable system or other video distributor. Contracts must periodically be renewed and renegotiated. Even between formal contract negotiations, program services must deal with distributors, coordinating new promotions with distributors, and negotiating over whether the program service will provide financial support for distributor promotions.

Selling efforts also continue. Services sometimes change their programming to implement new ideas, to respond to programming innovations of rival services, or to provide an improved but more costly service.[4] In other words, program services may redesign their products for the same types of reasons that firms in other

[4]Examples are the addition of National Football League games to the ESPN and TNT program lineups.

industries redesign their products. When they make these changes, program services must convince distributors that the new product is as good as the old, or is enough improved to justify its higher price. Maximizing the return to investments in redesign often requires additional selling effort.

1. Transaction Cost Economies

Transaction and selling costs per subscriber are likely to be lower when a program service can deal with, for example, a single MSO that represents 10 million subscribers rather than 10 distributors, each of whom can deliver 1 million subscribers, or 40 operators with 250,000 subscribers each. When dealing with the large MSO, the program service's selling efforts reach decision-makers that represent 10 million subscribers rather than decision-makers that represent only 1 million, or 250,000 subscribers. Total selling costs may well be higher for the larger MSO, if only because a greater investment in effort is worthwhile, but total costs are unlikely to increase enough to prevent a fall in selling cost per subscriber.[5] The per-subscriber selling and transaction cost for an MSO with 10 million subscribers will be lower than the per-subscriber costs for the smaller MSOs unless total transaction costs for the large MSO are 10 times as large as those for an MSO

[5]To the extent a program service increases its total selling effort for large MSOs because additional selling expenditures have higher payoffs, comparing the selling cost per subscriber for larger and smaller MSOs understates the cost efficiencies of dealing with the larger MSO.

with 1 million subscribers, or 40 times as large as those for MSOs with 250,000 subscribers. Although selling costs per subscriber may not continue to decline without limit as the number of subscribers served increases (i.e., although "constant returns to scale," or even "diseconomies of scale," may eventually prevail) there is likely to be a significant range over which economies of scale in selling exist.

There is another reason that selling costs per subscriber are likely to be lower when the program service deals with a large MSO that represents many individual systems. If the large MSO's program decisions are not completely centralized, some information about the program service still must be distributed to the system or regional managers that participate in making these decisions. At least some of the costs of this communication, however, will be assumed internally by the large MSO itself. In effect, the MSO incurs some of the cost of communicating with individual systems that the program service itself must bear when dealing with small, individual systems.

2. Effects on License Fees and Efficiency

If program services have lower selling and other transaction costs per subscriber when the distributors involved represent more systems and subscribers, then, all else equal, market pressures should result in larger distributors paying lower license fees per subscriber. That is, competition among program services results in their charging lower prices to those distributors to whom it is less costly to sell.[6]

This analysis also implies that when distributors pay different license fees because the costs of selling and distributing to them differ, each may still contribute the same amount per subscriber toward covering program acquisition costs. Program services must cover their costs of program acquisition and development by collecting fees from distributors that collectively exceed the services' selling and distribution costs. Moreover, the revenues collected from each MSO must at least equal the cost of distributing and selling to that MSO. However, the fact that one MSO pays a smaller per-subscriber fee than another does not indicate that the first MSO makes a smaller per-subscriber contribution to programming costs. This can only be determined if one knows the respective per-subscriber distribution and selling costs to the two MSOs.

When lower per-subscriber costs are reflected in lower per-subscriber license fees, the efficient distribution of programming is promoted. First, individual systems of a large MSO can buy rights to programming at lower prices than they could if the transaction costs of dealing with programmers were not reduced by being part of a large MSO. As a result, those systems supply their subscribers with more services, or set lower prices for service, or both, than if the systems dealt individually with program services.

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[6]This is analogous to the fact that Wal-Mart is able to command lower wholesale prices than are independent hardware distributors because manufacturers incur lower per-unit selling costs when they sell in large volumes.

That in turn, encourages more consumers to subscribe to services carried by the multichannel distributor.[7] In the longer run, lower programming costs may increase the channel capacity that a system chooses to provide. Both the short run and long run effects of lower wholesale service prices serve to improve economic efficiency and increase consumer welfare.

Increases in distribution made possible by lower distribution costs may also make some program services viable that would not be so if selling costs were higher, or if the rates to large MSOs could not reflect cost differences.[8] In general, the marginal costs of supplying a service to additional multichannel video distributors and subscribers will be lower than the average cost per subscriber. The additional license fees that program services receive as a result of being carried by additional distributors, and of reaching more subscribers on those systems, generally will be substantially greater than any additional costs incurred. Such an increase in net revenue may make additional services viable.

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[7]If the service is packaged in the basic tier, a lower price for the tier increases the consumer surplus that consumers receive from the package of services, which means that more consumers will be willing to pay upfront installation charges. Once having paid those "entry" fees, new subscribers may subscribe to enhanced basic or premium services, even if their prices are unchanged. Conversely, lower license fees and prices for pay services may encourage subscriptions to basic service.

[8]It certainly should not be presumed that forcing program services to offer the same per-subscriber rate to all distributors would allow all distributors to enjoy the rate now paid by distributors with the lowest rate. Rather, it is likely that the uniform rate for all distributors would exceed that lowest rate, perhaps by a substantial amount.

3. Volume Discounts and Competition Among Video Distributors

Many multichannel video distributors do not compete with one another as suppliers because they supply different geographic markets. The efficiencies just described are realized even when multichannel video distributors are not competitors. In other cases, however, multichannel video distributors are actual or potential rivals. In those cases, one distributor may pay lower license fees than a rival because program services have lower selling and transaction costs when dealing with that distributor. If so, the lower license fees will give that distributor a competitive advantage. This is not necessarily harmful to consumers.

It should not be presumed that lower fees based on cost efficiencies are available to only one distributor in a market. The competitive edge gained by a low-cost supplier is the incentive the market uses to encourage all firms to adopt techniques and procedures that reduce costs, including those that reduce transaction costs. If one distributor does not find a way to allow program services to deal with it at the same low cost as with its rivals, increasing the proportion of the market supplied by the distributor with lower costs yields efficiency gains for society. Furthermore, those efficiencies will be shared directly with consumers of the service when the more efficient distributor reduces its prices to expand its market share.

4. Summary: Volume Discounts and Efficiency

This discussion shows why one should expect that program services have lower per-subscriber transaction and selling costs in dealing with larger MSOs, and that, as a result, the license fees paid per subscriber will be lower for larger MSOs.[9] In these circumstances, the existence of significant volume discounts will promote efficiency in the supply of programming. As a result, preventing such a pattern of pricing across MSOs and video distributors of varying size runs a high risk of reducing efficiency and restricting the supply of programming.

A blanket prohibition on the use of volume discounts would in most cases risk a loss of efficiency where there was virtually no risk of anticompetitive effect. Certainly, where different prices per subscriber are charged to distributors that do not compete in any well-defined geographic market, there is no risk of harm to competition among rival distributors.

B. Other Sources of Differential Pricing

Economies in selling and transaction costs provide one reason why it would be efficient for different distributors to pay different per-subscriber fees for the same program service. This, however, is only one of many possible reasons why such pricing differences might exist and be efficient. We explain briefly some

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[9]Again, this does <u>not</u> mean that large MSOs are making disproportionately small contributions to the costs of program acquisition and production.

of these other reasons.

1. Introductory Discounts

Before introducing a new service, or committing resources that will substantially increase the cost of an existing service, a cable program service will seek contractual commitments from distributors that they will carry the new service, or will pay fees that will cover anticipated increases in program costs. Cable program services will seek these early commitments for a variety of reasons, including sharing with distributors the risks of sinking investments in program rights or production, avoiding being placed in the difficult position of bargaining with distributors after program investments already are sunk, and being able to adapt the programming to the demands of distributors.[10]

Despite these advantages, program services will find it difficult to get these early commitments unless they offer introductory discounts, i.e., better terms and prices to early signers than to distributors who wait until the service is operating or the programming change has been made. Distributors who sign early must be compensated with a lower price for bearing more risk. Early signers bear increased risk because, when they commit to carry a new service, or to pay a higher price for improved programming, the quality and value of the future service

[10]The ability on the part of buyers to make such commitments to new producers also reduces any possible market power on the part of existing sellers. For a discussion of this point see Easterbrook (1981).

will be more uncertain than for those distributors who wait to gauge the success of the new service or programming.

Increased uncertainty increases a distributor's risk that the service will turn out to be less valuable than expected and that the distributor will have committed to paying a price that makes carrying the service unprofitable. Increased uncertainty also increases the risk that the service will fail, and thus the risks that the distributor will not recover the start-up costs of launching the service on the system -- costs of channel realignment and of promotion -- and that it will have to bear the costs of launching a replacement service. If risk-averse distributors do not receive some sort of introductory discount, they will not be willing to sign up early and bear this increased risk.

In addition to differences in risk, there is a second reason that early and late signers may pay different prices. Once the new programming is aired, it may turn out to be either more or less valuable than expected. In principle, when programming turns out to be less valuable than expected, distributors who sign later may pay less than early signers. Program services that perform much less well than expected, however, also are disproportionately likely to fail, leaving fewer observations of this pricing pattern. What is left to observe are the introductory pricing patterns of surviving, relatively successful, services and programming changes, cases where early signers receive discounts both because they bore more risk, and because the service turned out to be more valuable than was initially expected.

More variation in pricing is created by introductory discounts than a simple difference between distributors who do and do not receive an introductory discount. Introductory discounts are likely to vary substantially in size. Not only may different program services offer different introductory discounts, but the same service may offer different discounts to different distributors. There is no reason to expect the distributor's perceived risk of committing early to be the same for all program services, and thus no reason to expect introductory discounts to be the same. Different distributors may receive different discounts for the same program service depending on how early they agree to take the new service (or the new programming) -- after the service is announced, shortly after the service begins, or after it is well established -- and not just on whether they are "early" or "late."[11]

Finally, introductory discounts vary depending on the nature of the commitment made by the distributor, and thus the amount of risk borne. The commitment made and the risk borne will depend on such contract terms as: the duration of the contract, the flexibility the distributor retains to vary the number of systems or subscribers that must receive the service or to change the tier on which the service is placed, and the circumstances under which

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[11]An analogy may be useful here. Broadway theater-goers who purchase tickets for the Broadway run before the show opens out of town may pay lower prices than those who purchase tickets for the Broadway run during the out-of-town tryouts who, in turn, may pay lower prices than those who purchase tickets during the New York run of a successful play.

the program service or distributor can renegotiate the contract. If commitments differ, introductory discounts will also differ.

A further complication is that it may be difficult to make meaningful comparisons of the magnitude of different introductory discounts. Contracts often specify more elaborate formulas for licensee fees than a fixed amount multiplied by the number of subscribers receiving the service, and introductory discounts can involve more than setting a uniformly lower amount per subscriber. Instead, contracts may specify that lower rates apply only to some base number of subscribers, or only to a base number that is adjusted in specified ways. Alternatively, license fees may be calculated as some discount of license fees paid by distributors who sign later contracts.

These formulas make the monetary value of the discount contingent on other developments. Different formulas affect not only the value of introductory discounts, but also the sharing of risk between program service and distributors. There is no reason to expect any single pricing formula to be adopted in all situations.

One term that obviously affects the value of the discount received is the period over which an early signer receives a lower price. Strictly limiting the period over which an early signer can receive a discount, however, may substantially limit the service's ability to write contracts that allow it to succeed. For example, the fact that a service does not grant discounts to distributors signing contracts one year after it begins does not imply that it was inefficient, or unnecessary, for it to have offered discounts throughout the duration of a three-year contract executed before the service began.

The discount is compensation for the risk implied by commitment, as evaluated at the time of commitment. The fact that the risk appears smaller during the last two years of the commitment is irrelevant. What matters is the aggregate value of the discounts received. Moreover, the term over which a distributor is compensated for bearing the risk need not be the same as the period over which risk is borne. For example, a new service might prefer to offer a smaller introductory discount per subscriber over a longer period in order to increase its cash flow during the first months of its operation. If the service had to offer the same aggregate discount over a shorter period, it might have to seek other, more costly ways to finance its early cash flow.[12] In these circumstances, requiring the service to shorten the period over which discounts are granted (without increasing their size) would reduce the aggregate size of the introductory discounts that could be offered, which could threaten the service's ability to get the commitments it needs to survive.

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[12] If cable operators were merely providing bank-like credit lines for new program services with the same information as is available to banks, then there would be no reason to suppose that operators would be more efficient than banks in performing this function. But if cable operators possess specialized information that could not easily (i.e., at low cost) be communicated to and verified by other third-party lenders, the efficiency reasons for operator lending become more compelling. For a discussion of such communication difficulties, see Williamson (1975, pp. 26-28).

2. Non-uniform Pricing Schedules

The license fees paid by a distributor do not always vary simply and directly with the number of subscribers. Rather than paying a simple, uniform price per subscriber, the average price paid per subscriber may vary, either by explicit formula or implicitly by contract negotiation, with the proportion of a distributor's subscribers that receives the service. The use of such pricing schedules means different distributors may pay different average rates per subscriber, even if they face the same rate schedule.

In addition, different distributors may face different pricing schedules. Such pricing schedules are used to improve the incentives a distributor has to expand the distribution of a service. Requiring the same schedule for all distributors might reduce the ability of services to adapt incentive structures to the circumstances of each distributor, which would inefficiently reduce carriage of the service and could threaten the viability of some program services.

Explaining these points requires an analysis of the purpose and effect of these pricing arrangements. Both program services and distributors often will have an incentive to use non-uniform pricing arrangements. Many of a program service's costs do not increase proportionately when the program service is distributed to more viewers. A program service incurs relatively low additional costs when more cable systems (or other distributors) carry its service, or when more subscribers to systems carrying the service sign up for their service. Certainly the marginal costs of reaching additional subscribers typically are much lower than the average total cost per subscriber of supplying a program service.

As with other services where marginal costs are substantially below average costs, this creates a dilemma for the supplying firms and an obstacle to achieving economic efficiency. As an example, assume that a program service currently has average costs per subscriber of 50 cents per month, but that the cost of being distributed to an additional subscriber is only 1 cent. Setting the price to a cable MSO at a uniform 50 cents per subscriber will restrict distribution of the service.

It is likely that the service will not be carried on some systems where its value to the system, and to subscribers, exceeds 1 cent per subscriber but is less than 50 cents per subscriber. Where the service is carried, rather than placing it on the basic tier, a cable system may make it part of an "expanded basic" tier in order to recover the additional cost to the system of 50 cents for each additional subscriber, or may even make it a premium service.[13] In this case, some potential subscribers who value the service at more than 1 cent a month, but at less than its price, will not subscribe.

This restricted distribution is clearly inefficient, since the

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[13]Even if the service is carried on a system's basic tier, a license fee of 50 cents per subscriber could inefficiently restrict distribution. The higher price paid by the cable operator may result in a higher basic subscription fee, reducing the number of subscribers to both this and other program services. Of course, the subscription fees set by cable systems also must recover costs other than program service license fees.

service is denied to consumers for whom the value of the service exceeds the additional costs of supplying it. The restricted distribution, however, also represents lost net revenue both for the program service and the distributor. The two parties jointly fail to earn revenue from those viewers who are willing to pay 20, or 30, or 40 cents, well above the additional cost of serving them, but who are not willing to pay 50 cents. Thus the program service and its distributors have an incentive to minimize the problem.[14] Charging all distributors a uniform price equal to marginal cost is certainly no solution; that would expand distribution but the program service could not recover its total costs. What program services and video distributors can do, however, is to set non-uniform pricing schedules.[15]

There are many ways to design such schedules, but all share a common feature: the amount by which the total license fee increases when one more subscriber receives the service is smaller than the average license fee paid per subscriber. To give examples of some license fee formulas that yield this result, the license fee might be calculated as an amount multiplied by the number of subscribers to basic service on all of an MSO's systems (regardless

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[14]Program services that sell advertising have an additional incentive to expand distribution since reduced distribution also reduces advertising revenues.

[15]An alternative, more direct way to deal with this problem is for the distributor and the service to vertically integrate and to transfer the service between themselves at marginal cost, or to recognize that carriage and pricing decisions should not be based on whatever is set as the nominal transfer price. This, too, can increase efficiency.

of how many of the systems carry the service), or as an amount multiplied by the number of basic subscribers on systems that carry the service (regardless of how many subscribers on these systems receive that service). The contract could specify a lower price for subscribers in excess of some threshold number, or it could specify that the price paid per subscriber is lower when a larger percentage of an MSO's subscribers receive the service.

An inherent characteristic of such non-uniform pricing is that the average price paid per subscriber will vary with the amount purchased by the distributor. If a program service were required to charge all distributors a uniform price per subscriber, regardless of the number of subscribers, it would be unable to use non-uniform pricing to give distributors an incentive to efficiently expand distribution of the service. The consequences would be reduced distribution of program services, reduced incentives for program services to invest in increased program quality, and a reduced number of program services that would be viable.

3. Signal Security and Collection Problems

We have implicitly assumed thus far that contracts are enforced as written: program services are paid the fee per subscriber and any other amount to which their contract with distributors entitles them. If program services are not confident they will receive full payment, however, they obviously will take that into account in determining whether and on what terms they will write a contract with a distributor. Here we focus on two possible reasons a program service would not be able to realize the revenue due under a contract. First, a distributor may have security problems that allow some households to receive the service without paying for it. Second, the financial condition of a distributor may mean that there is a substantial probability that it will be costly or impossible for the program service to collect all that is due under the contract.

Either of these problems would reduce the net revenue realized per receiver of, as opposed to per subscriber to, the programming below the amount called for in the contract. The program service would have to set higher contract prices to a distributor with one or both of these problems to achieve the same expected revenue per viewer that it would receive from a distributor with whom the contract could be enforced as written. Not allowing higher prices risks inefficiencies by denying the program service the revenues it may need to be viable, or by not allowing it to set higher prices where its costs are higher.[16]

Perhaps even more important, poor signal security and collection problems may lead to the diversion of subscribers from distributors who do enforce security restrictions, further reducing the revenues of the service. Consider the following numerical example. A program service sells to Distributor A with signal security problems for 50 cents per subscriber per month, the same

[16]Indeed, if the service cannot set a higher price per subscriber in such situations, the likelihood that it will prefer not to deal with the distributor at all is increased.

rate it charges all other distributors. To simplify the example, we assume there are no incremental costs from supplying the service to additional distributors or subscribers. Finally, we assume the distributor obtains 4,000 paying subscribers, but an additional 6,000 viewers are able to receive the service from Distributor A without paying.[17] If there is no competing distributor in this geographic market, the program service realizes revenues of $2,000 per month, or 20 cents per receiving household, rather than the 50 cents per subscriber called for in the contract.

If there is a competing Distributor B that also carries its programming, selling to Distributor A reduces revenues in a second way: it reduces license fee revenue from Distributor B. To continue the example, assume that, if the program service were not available from Distributor A, 80 percent of the 6,000 viewers who receive the programming from Distributor A without paying would have subscribed to Distributor B. Because there is a competing distributor, selling to Distributor A costs the program service $2,400 per month in lost revenue from Distributor B, which, in this example, is more than the revenues it obtains directly from Distributor A.

Program services may be particularly unwilling to deal with distributors with significant security problems, or may insist on higher contract prices, when that distributor has rivals without

[17]Alternatively, if the problem is collection rather than signal security, the equivalent example is that the distributor signs up 10,000 subscribers, but the program service is only able to collect 40 percent of the amount due under the contract.

such problems.[18] The program service behaves this way not because it desires or benefits from any increased exercise of market power, but because the existence of a rival distributor increases the revenue it loses when it fails to collect its entire contractual fee from one distributor.

Requiring program services to sell to all distributors at the same price, regardless of whether there were problems with security or collection, would have several inefficient consequences. First, program services would suffer reduced net revenue because of their inability to collect revenues for all subscribers that enjoyed their programming. That would reduce their incentives to invest in program quality, and could threaten the viability of some services. Second, in order to cover total costs, a program service might have to set a uniform price higher than the price distributors without these problems otherwise would pay, thereby restricting distribution of the service. Finally, requiring a uniform price would reduce the incentive of distributors to reduce their security and payment problems.

4. Effects of Other Contract Terms on License Fees

A contract between a program service and a video distributor contains many terms besides the license fee that affect its value to both buyer and seller. For example, contracts often specify how

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[18]We discuss below the effect of these problems on the decision of a program service to sell exclusive distribution rights.

much time the program service will make available for local advertising sold by the distributor, obligations of the distributor to provide various types of marketing services, on which of the distributor's tiers the service will be carried, and obligations of the program service to provide marketing services or to provide resources to support marketing directed by the distributor. The value of the contract also will be affected by the term of the contract and renewal clauses, and by what rights the distributor retains to add or drop the service on systems without triggering a renegotiation of rates.[19]

In principle, the fact that two distributors pay the same license fee per subscriber, or that they pay different license fees per subscriber, is not enough to establish whether or not they are purchasing on the same terms. That depends on the overall value of the two contracts. One distributor may pay a higher license fee per subscriber and yet prefer that contract to one received by another distributor that specifies a lower license fee but that requires greater marketing effort by the distributor or specifies constraints on where the service can be placed.

Comparisons are further complicated because different distributors may place different values on the same contract term. The contracts of two distributors for a service generally will specify that each receives the same amount of time for local advertisements. The value of that advertising time, however, may

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[19]Where agreements can convey exclusive rights, the extent of the exclusivity also will affect the value of the contract.

be worth substantially less to one of the two, with the result that the service is not worth carrying unless the license fee is reduced.[20] It would not be at all surprising to find that different distributors and different cable MSOs negotiated contracts with different mixes of license fees and non-price terms, making it difficult to compare, in any simple way, the "prices" that are paid.

C. Conclusions on Differential Pricing

Because contracts between cable program services and video distributors are complex, it will be difficult for regulators to determine whether, in any meaningful sense, different distributors are paying different per subscriber fees for the same service. Moreover, even if such differences can be identified, many can be justified by the contract efficiencies that they permit. The discussion above certainly does exhaust the reasons why prices could differ. It does show, however, that many of the circumstances in which program service set differential prices also are market circumstances in which differential pricing promotes efficiency.

As a result, any general attempt to constrain variations in per-subscriber fees among distributors is likely to create inefficiencies. Furthermore, many observed differences will be

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[20]For a similar analysis involving the determination of network compensation for television broadcast affiliates, see Besen et al. (1984, pp. 51-52).